

Czech Republic



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Investment Profile

2001



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Foreword

The Czech Republic is one of the most advanced countries in central and eastern Europe. The Czech economy began to grow again during the past year as a result of accelerated economic reforms and increased foreign direct investment inflows. EU accession negotiations are well advanced and the Czech government is strongly committed to them and very keen to accelerate their pace.

The government's active policy of attracting investors has resulted in increased confidence among international investors, and in terms of per capita foreign direct investment in 1999 and 2000 the Czech Republic took first place among the transition countries. Of almost US\$ 20 billion of total foreign direct investment achieved since 1989, more than half of this amount has been secured in the past two years.

We expect this positive trend to continue in the future, as a number of good investment opportunities are being prepared within the government's privatisation programme. We also welcome new greenfield investments, a number of which have been attracted by government support for industrial zones.

Foreign investment agency CzechInvest is ready to provide more detailed information about investment opportunities in the Czech Republic, the relevant legislation and investment incentives. Their contact details appear on page 11.

Pavel Mertlík

Governor of the EBRD for the Czech Republic
Deputy Prime Minister and Minister of Finance
of the Czech Republic

Introduction



The Czech Republic is one of the economically most advanced countries in central and eastern Europe. It has stable and well functioning democratic institutions and is firmly on the fast track for EU accession. The economic transition is nearly complete with almost 80 per cent of the GDP produced by the private sector and the legal structure to govern the economy already in place and being adjusted to EU standards. Following a few years of slowdown, the country's economy started to grow again in 2000, driven by high FDI inflows and growing domestic demand.

Political and economic transition

The Czech Republic became an independent state in 1993 following the break-up of Czechoslovakia. In the early 1990s the country launched a radically liberal economic transition programme that included a large-scale devaluation of the local currency, price and trade liberalisation, a rapid enterprise transformation, and an innovative voucher privatisation programme. Following the initial successes, macroeconomic performance started to falter in 1996, partly because of a lack of reform in the still state-dominated banking sector. In the spring of 1997, the government implemented stabilisation measures in two policy packages aimed at increasing market confidence although the authorities were forced to abandon the fixed exchange rate regime in May 1997. Between 1992 and 1998, Czech political life was dominated by the Civic Democratic Party (ODS) under the leadership of Václav Klaus. In 1998, the succession of ODS-led governments ended, and a minority Social Democratic Party government was installed. The new government has endorsed the main elements of the macroeconomic adjustments under way, in particular the prudent regulation of capital markets, and adoption of a working bankruptcy framework.

Challenges met and challenges ahead

In 2000, the Czech Republic managed to sustain a gradual economic recovery. GDP grew by 2.5 per cent, following three years of recession. Initially net exports followed by strong capital investment were the main drivers of growth, but domestic consumption also increased. The recovery is expected to be consolidated in 2001.

The Czech Republic has put strong emphasis on attracting foreign direct investment (FDI) by creating an attractive investment climate with competitive incentive packages as its main elements. As a result, almost US\$ 20 billion worth of foreign investment has been recorded since 1990, the highest per capita figures in the region. Foreign investors have been particularly attracted by the investment incentives package, and also by the new business zones with enhanced infrastructure provided by the municipalities, which are now also being established in the economically depressed regions. (See *Investment climate* below.)

The private sector accounts for almost 80 per cent of the GDP, a relatively high figure even by west European standards. However, the state retains large ownership stakes in steel mills, chemical companies, oil refineries, regional energy distribution companies, and telecommunication companies. The privatisation of many large enterprises in the energy, engineering and telecommunications sector is scheduled for 2001 and 2002. (See *Investment climate* and *Major sectors of the economy* below.)

The country has made significant progress to date with regard to the restructuring of large industrial enterprises, although the process is still far from complete. Concerning the energy sector, the state is still a majority owner in most of the enterprises, although private investors have gained substantial stakes in energy distribution companies. In 2000, the government announced an acceleration of privatisation of the sector. The opening of the energy market for competition is envisaged for 2005. (See *Major sectors of the economy* below.)

The insufficient stabilisation and restructuring of the financial sector has contributed to the country's difficulties in the mid-1990s. However reform has progressed in this area in the last two years. The authorities have started to privatise large state banks, with three out of four now owned by European financial institutions. The adjustment of the regulatory environment of the financial sector to EU standards has speeded up significantly, with a marked improvement in prudential regulation and supervision. However, capital markets remain underdeveloped and relatively unimportant compared with the dominance of large banks due to the lack of investor confidence following non-standard market practices that were widespread in the mid-1990s. (See *Financial sector* below.)

International relations

The Czech Republic is firmly anchored in the Euro-Atlantic community: in 1999 the country became a member of NATO and accession to the EU is progressing well. The advanced stage of the country's economic development has been recognised by the Organisation for Economic Co-operation and Development (OECD), of which it became a full member in 1995. The Czech Republic has also been active in seeking

closer economic and political ties with its neighbours. Its involvement in regional economic co-operation is within the framework of CEFTA (the Central European Free Trade Agreement), where other members include Bulgaria, Hungary, Poland, Romania, Slovakia and Slovenia. Relations with Slovakia are highly positive: the two countries share a customs union and a final settlement agreement on outstanding issues from the dissolution of the Czech and Slovak Federation was signed in the autumn of 1999.

EU integration

The Czech Republic is at the forefront of the enlargement process. The Europe Agreement with the Czech Republic was signed in October 1993, and entered into force in February 1995. The country's application for membership of the EU was presented in January 1996, followed by the start of accession negotiations in March 1998.

Since the launch of the negotiations, out of the total 31 chapters, 29 have been opened and 13 have been provisionally closed (fisheries, common foreign and security policy, external relations, customs union, small and medium sized enterprises, science and research, education and training, industrial policy, statistics, telecommunications and information technologies, consumers and health protection, free movement of goods and economic and monetary union).

Three pre-accession instruments financed by the EU are now available to assist the Czech Republic in its pre-accession preparations: the PHARE programme; SAPARD, which provides aid for agricultural and rural development; and ISPA which finances infrastructure projects in the fields of environment and transport (See *Major Sectors of the economy: Transport* below). In the years 2000-02 total financial assistance to the Czech Republic will amount annually to € 100 million for PHARE, € 22.1 million for SAPARD and between € 55 and € 80 million for ISPA. As regards the SAPARD Programme, it is based on two major priorities: improvement of production and marketing structures in agriculture and food processing (75 per cent of the funds) and economic diversification and improvement of rural infrastructure (24 per cent).

In November 2000, the EU published its annual report on the progress of the Czech Republic towards accession. This latest report has been the most upbeat that the country has received since 1997, as the rate of legislative alignment as well as recent political and economic developments were all given positive assessments by the EU. The main issues identified by the document are as follows:

Progress made:

- Improved economic and legislative reforms.
- Should be able to cope with competitive pressure and market forces within the EU in the near term.
- Macroeconomic stability has increased.
- Progress on further restructuring and privatisation of banks.
- Significant acceleration in the rate of legislative alignment with the EU law.
- Some progress in strengthening administrative capacity.
- Good progress in legislative alignment in key areas of the internal market.

Progress yet to be made:

- Reform of the public administration should be advanced.
- Certain key parts of the judiciary reform have yet to be adopted.
- Need to accelerate environmental reforms.
- Economic restructuring must be speeded up.
- Situation of the Roma minority needs to be improved.
- Fight against corruption and economic crime must be strengthened.
- Sustainability of public finances in the medium term must be assured.
- Efforts to privatise and restructure state owned enterprises must continue and corporate governance must improve.
- Delays in administrative and judicial reform.

For the full text of the latest EU Progress Report on the Czech Republic and other enlargement related information see:

www.europa.eu.int/comm/enlargement/czech/index.htm

Information on the PHARE programme is available on the EU Commission's web site:

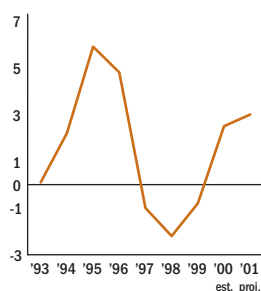
www.europa.eu.int/comm/enlargement/pas/phare/index.htm





Economic summary

GDP
% change



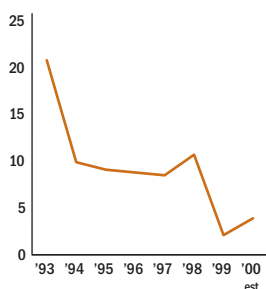
Following three years of decline, the Czech economy turned the corner in 2000 and embarked on the path of economic recovery and growth. The positive trend came as a result of the successful implementation of necessary structural reforms, such as bank privatisation and industrial restructuring, and the introduction of an attractive package of investment incentives. These measures have generated very high FDI inflows in the last two years that have provided a crucial impetus for the economy. The recovery is expected to be consolidated in 2001 and 2002, when the growth rate will be stabilised.

GDP growth

The reforms initiated in response to the currency crisis of May 1997, such as banking and capital market reforms, bank privatisation and the improvements made in the investment environment started to deliver their results in 2000, as the economy registered 2.5 per cent growth following negative GDP growth rates over the previous three years.

The economic recovery is expected to be consolidated further in 2001, when GDP growth is projected to reach 3 per cent. The recovery will be driven by gross fixed capital formation due to large FDI inflows in the past few years and continued growth in exports mainly to EU markets. The competitiveness of export-oriented producers is expected to grow as industry restructuring takes hold and the share of foreign-owned producers in the economy further increases. With an expected increase in private consumption and continued growth in investment activity, domestic demand will also grow, adding to the expansion of the economy.

Consumer prices
Annual average, % change



Inflation

Due to price deregulation and high oil prices, headline inflation almost doubled in 2000, and reached 4 per cent year on year in December 2000. Net inflation, which excludes the impact of deregulation and changes in indirect taxation, was 3 per cent at the end of 2000. Nominal wages grew faster than inflation, although well below productivity growth, an important factor that helped keep inflation under control. The decision to complete price deregulation by the end of 2002 and strong oil prices may affect the inflation rate in the next few years.

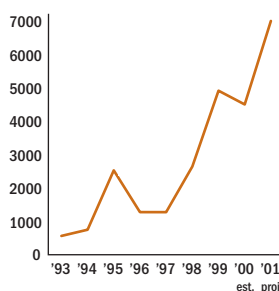
Current account
US\$ millions



Current account

The currency crisis of May 1997 was partly caused by an unsustainable current account deficit of over 7 per cent of GDP in 1996 and an emergence of negative budget deficit trends. A tight monetary policy, austerity packages, currency depreciation, and low commodity prices brought the current account deficit down to 2 per cent of GDP in 1999. The economic recovery led by high investment growth as well as high oil prices accompanied by depreciation against the US dollar resulted in a doubling of the current account deficit in 2000, to 4 per cent of GDP. However, this is comfortably covered by high FDI inflows, unlike the situation before the May 1997 crisis. Imports of consumer goods, which caused the high imbalances in 1997 and 1996, stayed relatively low in 2000. A further increase in the current account deficit is expected in 2001 and 2002, thanks to growing imports related to an upturn in private consumption and continuous investment demand.

Total FDI
US\$ millions, cash receipts, net



FDI and privatisation

The trend of high FDI inflows, amounting to an estimated US\$ 4.5 billion in 2000, continued as a result of investment incentives, renewed privatisation efforts and the economic recovery. The Czech Republic has attracted almost US\$ 20 billion in FDI since 1989, about half of which was invested

Source: Ministry of Finance of the Czech Republic and EBRD, January 2001

during the last two years, 1999 and 2000. Although large FDI receipts to date have been in the retail and real estate sectors, there have also been significant investment inflows in the banking sector and in industry, especially in automotive and electronics companies. The sectoral composition of FDI is favourable for medium term development, as the likely impact will be a stronger financial sector, faster and deeper industrial restructuring, and higher consumer demand.

Strong FDI inflows are expected to continue in 2001-02, partly because of renewed privatisation efforts by the government including sales of telecommunications and energy companies. (See *Investment climate* below.)

Government balance

The consolidated government budget deteriorated in the latter part of 2000 reaching 4.8 per cent of GDP for the whole year, owing to the restructuring related expenditures, high share of mandatory social expenditures and lower tax revenues. Excessive off-budget losses have been accumulated in the so-called transformation institutions such as Konsolidační banka, Česká finanční and the National Property Fund, as a result of banking sector restructuring before the privatisation of state-owned banks. There is also a fair amount of state guarantees mainly for infrastructure projects and debt of the health care system, but increasingly also for loans made to large industrial companies. The 2001 state budget targets a fiscal deficit of 4 per cent of GDP. However, the consolidated budget deficit is forecast to increase to about 9 per cent of GDP in 2001 in order to cover banking sector losses. Also, the central government budget deficit is expected to stay at 3-5 per cent of GDP in the coming years unless the government delivers a major reform of public finances, particularly social welfare expenditures.

Exchange rate

Following the devaluation of 1997 the Czech authorities no longer maintain any explicit exchange rate policy or target. Nevertheless, the Czech National Bank aims to limit the volatility of the currency. Tight monetary policy and strong FDI inflows have kept the currency relatively stable against the euro in the past few years. In the medium term some strengthening of the koruna is expected thanks to high FDI inflows. However, the Czech National Bank pursues an active policy regarding the elimination of the temporary appreciation tendencies linked to FDI inflows, and so the strengthening of the koruna is unlikely to reach an extent that could jeopardise export competitiveness.

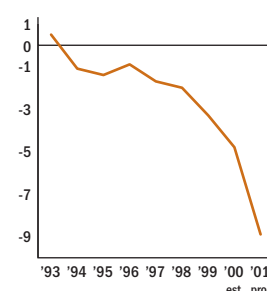
EU accession progress

The EU's expectation is that the country will be able to join the Union in the first wave of enlargement. The EU in its annual Progress Report on the Czech Republic noted that economic growth has finally picked up while inflation has remained low. The financial sector was singled out as one of the biggest remaining problems. The Czech government was urged to continue with steps concerning bank restructuring and privatisation. Bad loans amount to more than one-quarter of GDP and the regulation and supervision of banks, as well as the capital markets remains inadequate, the EU said. Continuing price liberalisation, restructuring public finances and improving the legal framework for enterprise activity were listed as other recommended priorities. (See *Introduction: EU integration* above.)

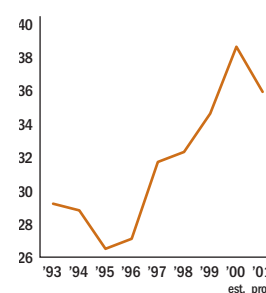
IMF recommendations

On 30 October 2000, the IMF published a statement summarising the conclusion of its staff mission to the Czech Republic. The IMF expressed its agreement with the macroeconomic policies the Czech government pursued to support recovery and sees only minor adjustment necessary in the coming period. The Fund recommended starting to consolidate public finances in 2001 through

General government balance
% of GDP



Exchange rate
Annual average, korunas per US\$



Source: Ministry of Finance of the Czech Republic and EBRD, January 2001

structural reform measures that will have a lasting effect on the fiscal deficit, while maintaining a broadly accommodative monetary policy. Failure to take timely fiscal action will add to demand pressures and may necessitate an inopportune monetary tightening just as recovery gathers momentum, which would result in a policy mix that could undermine the sustainability of the recovery.

Credit ratings

Standard & Poor's sovereign ratings, January 2001

Local Currency			Foreign currency		
Long-term	Outlook	Short-term	Long-term	Outlook	Short-term
AA-	Stable	A-1+	A-	Stable	A-2

Moody's country ceilings for foreign currency ratings, January 2001

Bonds and notes		Bank deposits	
Long-term	Short-term	Long-term	Short-term
Baa1	P-2	Baa1	P-2

Fitch IBCA foreign currency sovereign ratings, January 2001

Long-term	Short-term
BBB+	F2

Local currency long term ratings, February 2001

Moody's	Fitch IBCA
A-1	A+

Selected economic indicators

	1993	1994	1995	1996	1997	1998	1999	2000 est.	2001 proj.
GDP (% change)	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.8	2.5	3.0
Consumer prices (annual average % change)	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9	na
Current account (in US\$ millions)	456	-787	-1,369	-4,292	-3,211	-1,336	-1,058	-2,000	-2,300
General government balance (% of GDP)	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.8	-8.9
Trade balance (in US\$ millions)	-525	-1,381	-3,678	-5,877	-4,540	-2,554	-2,060	-3,400	-3,300
Total FDI (in US\$ millions, cash receipts, net)	563	749	2,526	1,276	1,275	2,641	4,912	4,500	7,000
External debt stock (US\$ billions)	8.50	10.70	16.55	20.85	21.35	24.05	22.62	23.00	23.00
Unemployment (% of labour force)	3.5	3.2	2.9	3.5	5.2	7.5	9.4	8.8	8.5
Exchange rate, annual average, korunas per US\$	29.2	28.8	26.5	27.1	31.7	32.3	34.6	38.6	35.9
Gross reserves, excluding gold (end-year, US\$ billions)	3.87	6.24	14.02	12.44	9.80	12.62	12.89	13.00	15.00

Source: Ministry of Finance of the Czech Republic and EBRD, February 2001

Investment climate



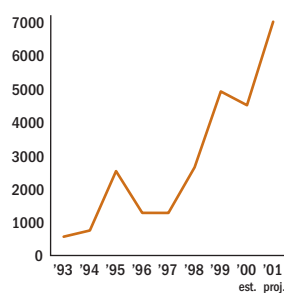
The Czech Republic has been one of the region's most successful countries in attracting FDI with over US\$ 20 billion worth of foreign investment recorded since 1990. The positive trend of very high FDI growth continued in 2000, as a result of an active government strategy to improve the investment climate. An improved and very attractive package of incentive policies and other measures, such as support to industrial zones, was put in place. Another reason for the FDI increase has been the invigoration of the privatisation process.

Foreign direct investment

The Czech campaign to attract foreign direct investment has been extremely successful over the last few years, as net FDI totalled US\$ 4.5 billion in 2000. For two years in a row FDI into the country doubled, clearly surpassing that of all other central and eastern European countries in per capita terms.

The sharp increase in FDI that started during 1998 and continued in 2000 is largely attributed to the introduction of investment incentives for both foreign and domestic investors. As at December 2000 there were 37 companies that had been awarded incentives to invest more than US\$ 1.5 billion. The most notable greenfield investments announced in 2000 were in the electronics and automotive sectors. (See *Major sectors*

Total FDI
US\$ millions, cash receipts, net



Source: Ministry of Finance of the Czech Republic

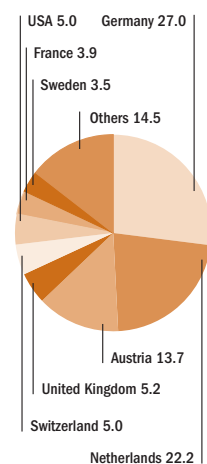
of the economy below.) Philips (Netherlands) started building a US\$ 624 million television plant in North Moravia in the autumn of 2000, which when completed will be the largest greenfield investment in the country's history. An important factor behind the increase of greenfield investments is the presence of suppliers of large multinational firms. Production in Czech affiliates of companies such as Matsushita (Japan) and Flextronics (Singapore) has already reached a level where it pays for their suppliers to follow them to the Czech Republic.

The second reason for the increase in FDI was the acceleration in the privatisation process, which has been implemented primarily through strategic foreign partnerships. This positive trend is expected to continue in 2001, as several energy utilities and telecommunication utilities, Český Telecom and České Radikomunikace, and the country's third largest bank, Komerční banka, are likely to be privatised. (See *Privatisation and restructuring* below.)

In the 1990-2000 period, by sector, the highest amount of FDI inflow was registered in

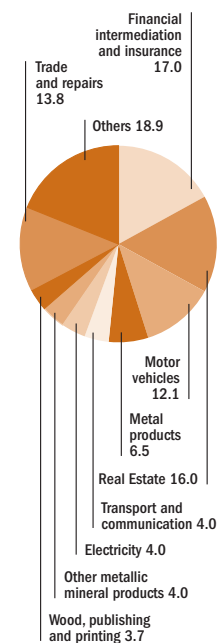
Foreign direct equity investment

by country of origin, Jan - Sept 2000



Foreign direct investment

by sector, Jan - Sept 2000



Source: Czech National Bank

Top 10 foreign investors, 1990-2000

Company	Country	Business	Investment (US\$ million)
TelSource	Netherlands, Switzerland	Telecoms	1,460
KBC Bank	Belgium	Banking	1,100
Volkswagen	Germany	Cars	900
International Oil Consortium	Italy, US, Netherlands	Oil refining	629
South African Breweries	South Africa	Brewing	619
Erste Bank Sparkassen	Austria	Banking	500
Assidoman	Sweden	Pulp and paper	499
ABB (Asea Brown Boveri)	Sweden, Switzerland	Electronics, engineering, power, oil and gas	450
Philip Morris	US	Tobacco	420
NRG Energy	US	Electricity generation	400

Source: CzechInvest; Prague Business Journal; EIU

financial services, wholesale trade and the manufacture of metallic and non-metallic products. In the coming years, the strongest growth is expected in telecommunications and financial services, and in the electronics and automotive sectors, as far as greenfield investments are concerned.

Investment policy and incentives

The Czech Republic in general has a legislative regime that provides a very positive environment for investors. Legally, foreign and domestic investors are treated identically and both are subject to the same tax codes and other laws. There are no restrictions on the repatriation of profits and transfer of capital abroad.

The new Act of Investment Incentives that came into effect as of May 2000 has been a very important factor behind the recent success in attracting high volumes of FDI. The new law codifies and to some extent simplifies the original scheme, first announced in April 1998, under which the investment incentives are granted.

The new Act offers the following incentives:

1. Tax holiday of 10 years for new companies and five years for expansions of existing companies.
2. Job creation grants in regions with a high unemployment rate (up to US\$ 5,000 for each new job).
3. Training and retraining grants in regions with high unemployment (up to 35 per cent of training cost).
4. Location incentives, including the provision of low-cost development land. In addition, municipalities receive subsidies for the development of infrastructure on location sites.

Under the new law, the basic conditions for granting incentives are:

1. The investment must be made into the manufacturing sector.
2. The investment must be at least the equivalent of US\$ 10 million, of which at least US\$ 5 million must be covered by equity.
3. The limit for investment is lowered to US\$ 5 million in regions with high unemployment.
4. Investment into machinery must account for at least 40 per cent of the total investment.

Additional incentives, not covered by the new law:

1. Duty free import of machinery and equipment.
2. Job-creation, training and retraining grants available directly from local labour offices.
3. Regional investment subsidies intended for job creation in depressed regions.
4. Support for small companies.

Potential investors can contact CzechInvest (See details below.) to request an Investment Incentives Manual that describes all the current eligibility criteria, specific conditions and application procedures.

Other legislation

Regarding another important issue that concerns investors, the protection of intellectual property, the legislation has been brought into broad compliance with EU directives in the last few years. It protects all intellectual property rights, including patents, copyrights, trademarks, and semiconductor chip layout design. The enforcement of legislation has also been strengthened by boosting the powers of the customs service and the Czech Commercial Inspection to seize counterfeit goods.

The latest EU progress report on the Czech Republic mentioned the insufficient functioning of market entry and exit mechanisms as an existing problem for foreign investors. The EU called for the simplification of the process of registering businesses and for more effective implementation of bankruptcy procedures. Similarly, the report also urged better co-operation between the police, the courts, the Securities Commission and other supervisory institutions to fight fraud and irregular business practices.

Supplier Development Programme

The Supplier Development Programme run by CzechInvest is designed to improve links between Czech suppliers and foreign-backed manufacturers operating in the Czech Republic. Programme activities fall into three categories:

1. Collection and distribution of information about Czech-based component manufacturers in the form of an online database (www.czechinvest.org).
 2. Organisation of meetings between foreign investors and Czech-based suppliers.
 3. Upgrading selected Czech suppliers to improve their financial and production management and also link them with sources of additional financing.
-

Free trade and industrial zones

There are eight free trade zones established in several cities throughout the Czech Republic. Rules for operations within a commercial or industrial customs-free zone are the same as in the EU. Materials, components and semi-finished products are exempted from customs duties or VAT if they are exported into a free trade zone. If the goods are then used in the manufacturing or processing of a final product that is then re-exported, it is also exempted from duties or VAT. Duties and VAT are applied on the declared value of the goods if they are cleared for free circulation within the Czech Republic.

The Czech government has also made significant steps to back up the investment incentives scheme with a programme of industrial zone construction. Over CZK 550 million in government funds was used in 1999 and 2000 to develop 51 sites which can be ready for potential investors within a minimal period of time and where the local authorities now offer land to manufacturing investors at a significantly reduced cost. All zones prepared so far have been between five and 50 hectares in size. A database of industrial sites is available on CzechInvest's website: www.czechinvest.org

Markets and trade

The Czech Republic is a member of the World Trade Organisation (WTO), implements the Uruguay Round Agreements and has adopted a tariff code with an average tariff rate of 4.7 per cent and 9.3 per cent for agricultural products.

The EU is the country's leading trade partner, accounting for 69 per cent of exports and 62.3 per cent of imports in January-October 2000. The Czech Republic has an association agreement with the European Union. The two sides are lowering and/or eliminating tariffs on an increasing number of industrial products under the agreement. A high level of compatibility has been achieved between the customs legislation of the Czech Republic and the Community *acquis*.

The Czech Republic is a member of the Central European Free Trade Agreement (CEFTA) that also includes Slovakia, Poland, Bulgaria, Hungary, Romania and Slovenia. The Czech Republic offers more favourable customs duty rates on products originating in these member countries. There is also a customs union in place with Slovakia that covers all types of goods originating in the territory of the two countries.

Excise taxes are imposed on the following goods produced or imported into the Czech Republic: Fuels and lubricants, tobacco products, beer, wine and liquor.

Trade structure and balance by groups of countries

	Export structure %	Import structure %	Trade balance in CZK million
Group of countries, countries	1-10/2000	1-10/2000	1-10/2000
World, total	100.0	100.0	-91,958
of which:			
Developed economy countries	75.1	71.9	-37,417
of which: EU	69.0	62.3	4,185
Germany	41.0	32.6	47,255
Austria	6.1	5.0	5,424
European countries with transitional economies, incl. CIS	21.1	21.2	-19,974
of which: CEFTA	17.0	12.9	25,602
Slovakia	7.6	6.2	7,500

Source: CzechTrade

CzechInvest

CzechInvest is the Czech Republic's foreign investment agency. It offers potential investors a range of services, such as:

- Information provision.
- Assistance in application for investment incentives.
- Assistance in selection of potential building plots suitable for production facilities.
- Aid with finding suitable production facilities or joint venture partners.
- Assistance in finding potential Czech suppliers or joint venture partners.
- Assistance in dealing with bureaucracy at both national and local levels.
- Organisational aid and execution of visit programmes.
- Post-investment care.

For more information:

Štěpánská 15

120 00 Prague

Czech Republic

E-mail: marketing@czechinvest.org

Web site: www.czechinvest.org

Privatisation and restructuring

Privatisation

The government re-invigorated the privatisation process in 2000. In the telecommunications sector, the privatisation of Česká radiokomunikace, a large telecommunications firm, is expected to be completed soon. Similarly, the sale of Český Telecom,

the majority state-owned fixed line monopoly, was postponed to 2001. (See *Major sectors of the economy: Telecommunications* below.) In the financial sector, a 52 per cent of Česká spořitelna, the second largest bank, was sold and the privatisation of the last large commercial bank, Komerční banka, is expected to be completed in 2001. The remaining 30 per cent state share in Škoda Auto was sold to Volkswagen in June 2000. (See *Major sectors of the economy: Automotive* below.) Finally, the partial privatisation of the Czech national air carrier, ČSA, was also launched in late 2000. (See *Major sectors of the economy: Transport* below.)

The other major privatisation event of 2001-02 will be the forthcoming sale of several utility companies (water, electricity and gas), for which the government agreed on the privatisation methods in late 2000. (See *Major sectors of the economy: Energy* below.) Privatisation of the main Czech power utility, České Energetické Zavody (ČEZ) and of Transgas, the main gas distributor, is likely to be launched in 2001. In the water sector, the Prague Water Company (PVK) was sold in early 2001 to Prague Water CGE-AW, a French-British consortium of Vivendi and Anglian Water. (See *Major sectors of the economy: Water management* below.)

Restructuring

The legislative framework for industrial restructuring was strengthened in 2000. A new amendment to the bankruptcy legislation, enacted in May 2000, aims at strengthening creditor rights and increasing the efficiency and speed of bankruptcy procedures.

A handful of large-scale industrial firms are currently undergoing a lengthy state-backed restructuring process. With mounting problems, several were declared bankrupt in late 1999 and throughout 2000, such as CKD and ZPS Zlin (both engineering firms). Others avoided the threat of bankruptcy by reaching out-of-court settlements with their creditors (including the state), such as Zetor Brno (engineering) and Vitkovice (metallurgy). Some companies were sold to foreign strategic investors, including engineering firm Vagonka Studenka, chemical company Moravske Chemické Zavody and ZPS Zlin.

A significant share of the non-performing portfolio of the Czech state-owned banks has been transferred to Konsolidační banka. The bank successfully launched the sale of the first part of its portfolio to a strategic investor at the beginning of 2001.

Taxation and social expenditure

Czech tax codes are generally in line with European Union tax policies. The Czech government has continued its programme of income tax reductions, and as of 1 January 2000, the corporate income tax rate was lowered from 35 per cent to 31 per cent, and the tax rate for the highest tax bracket for personal income tax came down from 40 per cent to 32 per cent. Employers' and employees' social insurance contributions are, respectively, 35 per cent and 12.5 per cent. The value-added tax (VAT) applies to all goods, both domestic and foreign, sold within the Czech Republic. The VAT rate is generally 22 per cent, although a lower VAT of 5 per cent is charged on selected goods, such as food and pharmaceuticals. The Czech state runs a relatively large and expensive social welfare system. Transfers to households from the budget were 53 per cent of total expenditures in 1999, equivalent to 20 per cent of GDP. The largest item in the state social system is pensions, expenditures on which are above 10 per cent of GDP. The country relies on a pay-as-you-go system (Pillar I) and also has a small but growing voluntary pension fund system (Pillar III). (Pillar II, a fully funded mandatory defined contribution scheme that was recently established in Poland and Hungary, has not been introduced yet.) The minimum retirement age is to increase gradually to reach 62 years in 2006. Since the early retirement age has become an increasing fiscal problem, the government is implementing stricter criteria more in line with actuarial principles.

Major sectors of the economy



The enterprise sector in the Czech Republic has been developing rapidly in the last years largely as a result of sharply increased foreign investments. The fastest growing manufacturing sectors have been automotive and electronics. A large number of the world's leading manufacturers have established plants in the Czech Republic and they continued to expand their facilities in 2000. The government has been implementing a restructuring programme in the engineering and metallurgy industries. The liberalisation and privatisation in the utility and telecommunications sectors will create huge opportunities for foreign investors.

Electronics

The Czech electronics sector has been undergoing large-scale expansion and has been one of the leading recipients of FDI over the last few years. This trend continued in 2000, as several of the world's leading multinationals continued to launch investment projects. The most notable is Philips (Netherlands), which is building a US\$ 500 million television plant in Hranice, northern Moravia. When completed, this project will be the largest green-field investment in the country's history. (See case study below).

The investment boom has been facilitated by the government's generous incentive programmes and the availability of a number of high tech investment parks, which have attracted several electronics firms to the Czech Republic rather than Hungary or Poland, its main regional rivals, as the location for new major assembly and production plants.

Matsushita Television Central Europe (MTCE), the regional subsidiary of the Japanese electronics firm, is one of the largest investors in the Czech electronics sector. The company already has two Czech facilities, one of which produces television sets and was built in 1997 with an investment of US\$ 66 million in Plzeň, and another that produces electromagnetic relays, located in Plana in the north-western part of the country.

In September 2000, Matsushita announced plans to increase its Czech production facilities by transferring part of its TV production activities from western Europe in order to achieve higher competitiveness in the new location. It plans to invest a further US\$ 72 million in the Plzeň plant over the next three years. The extension of the facilities aims to raise production to 1.3 million television sets per year and to create 1,400 new jobs. The Czech government has promised Matsushita extra incentives for its new investment plans including five-year tax holidays, tariff breaks on imports of high-tech equipment and a subsidy for staff training.

Matsushita has decided on the construction of a new US\$ 82 million mobile phone plant. The facility would create about 500 jobs and produce 20 million Panasonic telephones per year, double the output of the country's second European factory in the United Kingdom.

Besides Matsushita, several other Japanese manufacturers, namely Aisan, Daiho and Tatsuno, also started investment programmes in 2000. The three companies have announced plans to invest a total of US\$ 32.5 million. Aisan, one of the largest Japanese manufacturers of car components, is to invest

Philips: the largest ever greenfield investment in the Czech Republic

Dutch electronics giant Philips signed a document of intent with the Czech government and then started the work on building a US\$ 624 million plant in North Moravia to build advanced television screens. Philips is the largest foreign green-field investment in the country's history.

After surveying 66 sights in several countries, Philips settled on Hranice na Morave in North Moravia, which has a history of electronics manufacturing, but suffers from a jobless rate of 15.3 per cent – far above the national average of 8.8 per cent. The government expects other companies to follow Philips's investment. The plant is almost certain to provide contracts for Czech suppliers like glass manufacturers.

The Hranice plant will produce "super flat" screens for Philips's latest television, which the company says, is on the vanguard of TV technology. The plant will employ more than 1,000 workers once completed, and will represent an investment of US\$ 624 million. Philips also will invest in technical training and research and development projects in the area, which local officials hope will contribute to long-term stability in the region. To lure Philips, the government offered an incentive package that includes a 10-year corporate tax break broken into two five-year segments, the second of which is capped at the maximum level of the first. Philips must re-invest the tax savings, use it to pay for service or supply purchases from Czech firms, according to the agreement. The company will also be able to import duty- and VAT-free machinery and will get subsidies for each new job it creates, up to US\$ 6,000 per job. To sweeten the deal, the national and local governments will pay CZK 7 million to build infrastructure on the 60-hectare site. When completed, it will be the second largest plant of its kind in the world, producing over 8 million television screens per year.

US\$ 17.5 million to construct a new plant in the Louny industrial zone, specialising in the production of fuel pumps for diesel motors. Daiho Industrial will invest in the Borska Pole industrial zone in Plzeň, where it will produce plastic TV cabinets for Matsushita. The new plant, worth US\$ 10 million, will employ 300 people and production should start in mid-2001. Tatsuno, the world's fourth largest producer of pumps, has established a joint venture, Tatsuno Benc Europe (TBE), with Benc, a Czech pump producer. Benc holds 80 per cent of the joint venture and will be in charge of production, while TBE will focus on commercial activities. Tatsuno plans to invest over US\$ 5 million in new equipment and a 500-square-metre plant.

Another multinational electronics firm to have made large greenfield investment in the Czech Republic is Flextronics International (Singapore). In November 1999, **Flextronics International** started operations at its electronic and telecommunication components plant in the Brno industrial zone, Černovické terasy. The new plant will employ up to 3,000 people and is designed to be a state-of-the-art facility with world-class equipment.

Telecommunications

Telecommunications has been one of the most exciting and rapidly developing sectors of the Czech economy in 2000. Major developments were the birth of a new telecommunications law that defines future liberalisation steps, the ongoing privatisation of two of the industry's major players, Český Telecom and České Radiokomunikace, and also the appearance and expansion of new technology operators and internet providers.

In May 2000, the parliament approved the new telecommunications law, a key legislation setting the framework for liberalisation and regulation of the industry. The Act opens the fixed line telephony sector to competition by ending Český Telecom's monopoly from January 2001. Český Telecom contenders will be allowed to start laying their own lines by 2001, but call-by-call selection of operators will only be available for Český Telecom's 4 million customers as of July 2002. The portability of telephone numbers – allowing users to transfer their existing numbers to another provider – will be possible from the start of 2003.

The full opening of the telecommunications sector is in line with WTO and EU requirements and is likely to result in further improvements in the fixed-line segment of the telecommunications sector. Several large foreign investors – including Deutsche Telekom, RWE (both Germany), Tele

Danmark (Denmark), AT&T, MCI (US) and British Telecom (UK) – have already signalled their intention to enter as deregulation makes it permissible.

In its latest progress report on the Czech Republic, the EU noted that telecommunications policy has developed strongly along the lines of EU practice so far. The report identified the enactment of the new telecommunications law and the remaining pieces of secondary legislation as urgent priorities.

The sale of the majority of the state's shares in Český Telecom, the fixed line monopoly, was postponed until 2001, after KPN.

Mobile telephony

The mobile telephone market continued to develop at an impressive speed in 2000. Almost 40 per cent of the country's 10.3 million population were using mobile phones by the end of 2000, up from 19 per cent at the end of 1999 and 9 per cent in 1998. The two market leaders, Eurotel and RadioMobil, registered around 1.5 million users each, while Český Mobil's client base was 165,000 customers seven months after the company launched its services in March 2000. Projections are also optimistic, as analysts predict that EuroTel should see its subscriber base increase 279 per cent during 1998-2005. Second- and third-place operators RadioMobil and Český Mobil, respectively, are expected to divide almost 60 per cent of the market between them, but mostly in the low-use residential rather than the more lucrative business market.

Foreign telecom companies are actively involved in the mobile market. Český Mobil, which started operating in November 1999, is controlled by a consortium of Canada's TIW and the Czech bank IPB. (In January 2000, the EBRD decided to subscribe shares worth US\$ 40 million in TIW's subsidiary, TIW Eastern Europe N.V.) Eurotel is 51 per cent owned by Český Telecom and the remaining shares belong to a joint venture of Bell Atlantic (US) and Media One International (US). Deutsche Telekom (Germany), which jointly owns Radiomobil with České Radiokomunikace, increased its stake in the mobile company from 49 per cent to 60.8 per cent in summer 2000. CR is due to receive a US\$ 550 million payment from Deutsche Telekom as compensation for giving up control of Radiomobil. In October 2000, the Czech Telecoms Ministry recommended that the government issue four third generation (UMTS) mobile phone licences. Three licences are to be offered for a pre-set fee for the three existing mobile operators and the fourth concession will be open to an international tender. All four licences are likely to be awarded in the second half of 2001, with the planned launch of high-speed UMTS services in 2002.

(Netherlands) suddenly withdrew its interest in buying additional shares from the state in August 2000, due to commitments on western markets. Another giant deal for the Czech telecom market, the sell-off of 51 per cent of České Radiokomunikace (CR), the second largest actor in the telecoms market, is now in progress. CR provides television and radio broadcasting, and holds a 39 per cent stake in Radiomobil, a mobile telecoms operator, and a 50 per cent share in Contactel, an internet and data subsidiary.

Internet

The Internet segment of the market was also booming in 2000. International Internet service providers made a large number of acquisitions and invested heavily into network extensions. Telekom Austria has bought the Czech Republic's largest Internet provider, Czech OnLine, the first local provider to offer free net access in the country. The Austrian telecoms firm acquired the shares from venture capital fund DBG Osteuropa Holding, whose investors include Deutsche Bank (Germany), Mitsubishi (Japan) and the EBRD.

Deutsche Telekom (DT) has acquired a 51 per cent stake in PragoNet, a municipal telecommunications network provider in Prague. DT plans to expand PragoNet's services within the city as well as to push into investment-heavy areas of the western Czech Republic. Prague-based networks are clearly the most advantageous with the city accounting for almost half of Český Telecom's business, but covering only 12 per cent of the population. Another actor, Global TeleSystems (US) is planning an investment of CZK 3 billion (US\$74.4 million) to expand its Czech network.

Another Internet service provider, Contactel, a 50-50 joint venture between České Radiokomunikace and Tele Danmark, also strengthened its position on the market with the purchase of network operator Cesnet in March 2000. The network, built to connect academic institutions and for which Contactel paid CZK 775 million (US\$ 22 million), gives the company two key advantages: a local wireless high-speed data network of its own and a boost in client base.

Nationwide electricity producer ČEZ plans to enter the telecoms market after forming its own telecommunications subsidiary ČEZTel. The company will use ČEZ's network capacity, a 2,500-kilometre fibre-optic network that provides a chance to vertically integrate into distribution, with direct access to the regional customer base. ČEZ has chosen Vivendi (France) as the partner for ČEZTel. The French firm will gain a 66 per cent stake in ČEZTel.

In October 2000, the Czech Telecommunications Office issued three nation-wide fixed wireless access (FWA) network licences following a tender that ran with the exclusion of the current wireless operators. The winning bids came from BroadNet (Belgium); GiTy/StarOne, a consortium of local telecom company GiTy and StarOne (Germany); and Nextra, a unit of Telenor (Norway). The network will allow for high capacity data transmission to end-users, making Internet connections much faster than traditional telephone lines.

E-commerce

E-commerce in the Czech Republic has grown exponentially in recent years. Internet penetration is estimated at between 500,000 to 1.3 million users and the total value of the Czech Internet market has been estimated at US\$ 70 million in 2000 and is expected to increase tenfold by 2002. Specific e-commerce segments showing the fastest growth are business to business (B2B), Internet banking, business to customer (B2C) and information system development including training and education.

B2B and B2C have very high potential for rapid growth. There are currently 1,900 stores online, a 1,000 per cent increase from the previous year. Approximately 10 new virtual stores open on the Internet every day. In addition, the structure of the product/service mix has changed. The most frequent goods sold on the Internet in 1999 were appliances, books and CDs. From early 2000, the sale of services, such as air tickets, have held first position followed by the sale of mobile phones, books, hardware, software, food and flowers. High growth is expected in market segments such as travel services, hotel and ticket reservations and car rentals.

Internet banking has also been developing rapidly in the last two years. Internet banking has a very high potential for growth in the Czech Republic. There are two leading banks in this sector, e-Banka and Citibank, followed by other local and foreign banks that have just started to develop their online services.

A law on electronic signatures was passed by the Czech Parliament in July 2000 and it was the first of its kind to be introduced in central and eastern Europe. It fully complies with current EU law and promotes e-trade and transactions by accepting electronic verification of signatures and signing of contracts and documents. Legislation for e-commerce taxation and customs legislation is also being developed and harmonised with the EU, OECD and WTO.

Energy

The Czech Republic has taken considerable steps to diversify energy resources and their import routes in the 1990s. The use of coal, the dominant energy source, has been declining, giving a larger share to natural gas and nuclear energy. A new oil pipeline connection to Germany, and a long-term agreement with Norway concerning the supply of natural gas has weakened dependence on imports from Russia. The environmental aspects of energy production and consumption will be an important issue as the country works to harmonise its standards with those of the EU.

The government made serious advances in energy sector reform in 2000. By the end of the year the government adopted the new Energy Law that establishes a framework for the gradual increase of competition in the energy market between 2002 and 2007. Full liberalisation is not envisaged before 2007, although large customers will be able to freely choose suppliers by 2002.

In October 2000, the government approved the privatisation method for the electricity sector. The main Czech power utility, České Energetické Zavody (ČEZ) and six of the existing eight regional distribution companies will be sold as one company to a single strategic investor. The state holds a 68 per cent stake in ČEZ but intends to keep a 10 per cent minority interest in the new entity. The two remaining regional distributors, Pražská energetika and Jihočeská energetika, will be privatised separately, as the state currently has only a minority interest in them. Moreover, the government intends to privatise only ČEZ's production and distribution activities, retaining control over its transmission subsidiary, Česka Energetická Přenosová Soustava (ČEPS).

The government has also drafted plans to sell Transgas, the monopoly gas distributor, and seven regional gas distributors as a package together. As a first step Transgas will be transformed from a wholly owned government company into a joint stock company by the end of 2000. Transgas has long-term supply contracts with Gazprom (Russia) and with Norway to satisfy the rapidly increasing domestic demand for natural gas.

As a necessary precondition for privatisation, the authorities agreed the adjustment of energy prices to be completed by the end of 2002, resulting in an increase in household electricity prices by a cumulative 47 per cent and household gas prices by a cumulative 25 per cent. The first price increases took place at the beginning of 2000, followed by another increase

Temelin nuclear plant

The Temelin nuclear plant was activated in October. The new plant belongs to ČEZ, the country's main electricity generator and distributor. The facility consists of two reactors that are Russian designed, but modified and fitted with western control systems and nuclear fuel by US firm Westinghouse. The operation of Temelin will raise the share of nuclear energy in ČEZ's output from 17 per cent to 31 per cent and in parallel will reduce the share of coal in power generation from 64 per cent to 54 per cent. Neighbouring Austria has been opposing the plant on safety grounds, despite the fact that the International Atomic Energy Agency (IAEA) has positively assessed the plant's safety standards and the Czech authorities have fully implemented all the agency's recommendations.

Harpen ČR district heating loan facility

Improved heating services and environmental performance are the goals of a € 25.4 million debt facility arranged by the EBRD and Commerzbank Praha to Harpen ČR, an operator of district heating projects. The 13-year credit – including € 16.9 million from the EBRD – is being extended in local currency to Harpen ČR, while Commerzbank Praha is co-financing the project with a further € 8.4 million.

Harpen ČR has extensive experience in leasing, refurbishing and managing small district-heating plants in the Czech Republic based on long-term agreements with municipalities, businesses and residents. The company is a 100 per cent owned subsidiary of Germany's Harpen AG, that through its subsidiaries leases and operates 180 district heating projects in the Czech Republic, Germany, Hungary and Poland. The majority shareholder of Harpen AG is RWE, one of the largest power utilities in Europe.

The loans will finance energy-efficiency projects being developed by the company, with the aim of reducing energy consumption and improving heating services while maintaining – and sometimes lowering – customers' heating bills. The investments should also significantly improve the environmental performance of the plants, by reducing emissions of greenhouse gases and air pollution. The project is expected to advance private sector participation in the financing and operation of municipal services in the Czech Republic, a sector where public management has been the norm before. Moreover, the EBRD's involvement should serve to reassure the private investors in the sector that the current process of liberalisation of the heating sector will not be reversed.

at the beginning of 2001, but recent international oil price rises necessitate larger price adjustments than originally anticipated.

Even before full privatisation, there is already important foreign involvement in the Czech utility sector, as several foreign strategic investors have, over the past years, bought minority shares in the distributors on the open market and from municipalities. Investors include E.ON, RWE, Ruhrgas, VNG (all from Germany), Gas de France and TXU Czech Investments Ltd (US). A foreign investor that is leaving the market is TXU Czech Investments Ltd (UK-US). TXU announced in December 2000 its intention to sell its stakes in heating utility Teplárny Brno. Three German companies, RWE, Geso and Ruhrgas, even hold majority stakes in Pražská energetika (Prague electricity) Pražská Plynárenská (gas) and Pražská Teplárenská (heating).

Transport

The Czech Republic has an advanced transport infrastructure. It possesses the densest railway network and the longest extent of motorway per capita among the central and east European countries. Further investments were carried out in the last few years to bring the sector to the western European level of development and to align legislation with the *acquis*. The sector is benefiting from the EU-ISPA Programme, which is providing grants (€ 55-80 million annually in the period 2000-01) for transport and environment projects in the applicant countries. The main priorities of the programme are road network development, railway infrastructure development and waterway transport development in the area of transport, and drinking water/waste water, air quality and climate protection and waste management in the area of environment.

Roads

The Czech government considers the modernisation of the stretches of the Pan-European Transport Network which cross its territory as a priority. It spent 1.36 per cent of GDP in 2000 on the construction of the D5 motorway (from Prague to Nuremberg) and the D8 motorway (connecting Prague to Dresden and Berlin), both parts of Pan-European Transport Corridor IV. Private sector involvement is being considered to speed up motorway construction in northern Moravia. The government has stated that the construction of the D-47 motorway running from northern Moravia to Poland may possibly be achieved with foreign capital investment.

The harmonisation of road transport to EU regulations is well advanced. Outstanding issues include certain fiscal and social rules and safety requirements.

Railways

The reform process of the state railways, the most important mode of transport, entered its planning stage in 2000. The restructuring is much needed as the state railways' productivity has decreased by 30 per cent in the last 10 years despite downsizing of the labour force by a third over the same period. The railways' debt amounts to 1.6 per cent of GDP and payment arrears are negatively affecting the performance of private servicing firms. However, there are a few successful operators of small private rail lines and the upgrade of the main cross-country railway corridor is proceeding despite procurement problems. The US Trade and Development Agency has financed a study to determine how to restructure České dráhy (Czech Railways). The study will help České dráhy to plan its privatisation, implement the Transformation of Czech Railways law, and ensure compliance with EU railway directives. The study will also establish a restructuring framework that will facilitate access to international funding and foreign direct investment.

Aviation

The Czech national carrier Czech Airlines (ČSA) has been invited to join the SkyTeam Alliance, dominated by Air France and Delta Airlines (US), and its official entry is expected to take place in April 2001. The Czech government has announced plans to sell a 35 per cent share in ČSA. Air France has signalled its interest in purchasing the share, a move that would consolidate ČSA's integration into SkyTeam Alliance. Air France has already had a strategic partnership with ČSA's in the past. The French carrier took a 20 per cent stake in ČSA in 1992, but then sold it back to the government in 1994. EU harmonisation in the field of air transport is advanced, with independent bodies for the investigation of air accidents and for slot allocation yet to be established.

Automotive industry

The automotive industry is one of the fastest growing and most successful sectors. Škoda Auto, part of the Volkswagen Group, is the largest Czech industrial enterprise and produces nearly 10 per cent of all Czech exports. In addition to Škoda, in total there are around 120 foreign-owned automotive components firms now operational in the country. Czech-based automotive sector suppliers are mostly supplying important car manufacturers in Germany, Poland, Slovakia and Hungary. Czech-based suppliers are exporting to Ford, VW, Audi, Mercedes, BMW, Opel, Volvo, Seat, Mitsubishi, Toyota, Jaguar, Chrysler, Suzuki, Honda, Nissan, PSA, Renault, Fiat, and Saab.

The industry's flagship is car manufacturer Škoda Auto. Since May 2000, the company has been 100 per cent owned by Volkswagen, after the Czech government sold its remaining 30 per cent stake to the German manufacturer for US\$ 300 million. Volkswagen entered Škoda in 1991. Under its leadership Škoda has enjoyed one of the greatest success stories in the region. It introduced new models based on Volkswagen group platforms, built a new factory to assemble the mid-sized Octavia and has begun building a CZK 17 billion (€ 500 million) engine and transmission plant. Škoda employs about 21,000 people and is a key customer for many domestic part makers. Škoda Auto exports to 64 markets compared to 23 when VW took over. It has assembly operations in Poland and Bosnia and Herzegovina and plans for other emerging markets. In 2000, Škoda Auto was the fastest growing division in the Volkswagen (VW) group: it sold a total of 435,403 cars, a year on year hike of 13 per cent.

The Czech truck and commercial vehicle sector has been undergoing reorganisation in the last years. Avia, a manufacturer of light trucks in the 3-6 and 6-10 tonne ranges, is majority-owned by the Korean group Daewoo, which has invested nearly USD 300 million. Karosa, the country's former monopoly bus manufacturer, was purchased by RVI (Renault Group) and is now part of the Iris Group, Renault's joint venture with Iveco (Fiat).

Engineering

The manufacture of machinery and equipment has traditionally ranked among the most important sectors of the Czech economy. The sector employs some 170,000 and accounts for 12 per cent of value added within the Czech manufacturing industry. Over 70 per cent of engineering products are exported, of which approximately 60 per cent to European Union countries.

The engineering sector has proved to be one of the most attractive manufacturing sectors for foreign investment and over 15 per cent of the total inflow of foreign direct investment since 1990 has gone to this sector. Strong educational and training facilities coupled with the traditional strengths of Czech engineering firms have stimulated the influx.

The largest Czech engineering company is Škoda Plzeň, a well known company in many export markets for its high quality products. However, the firm has accumulated increasingly serious losses in recent years. Currently, Škoda Plzeň is implementing a restructuring programme with the assistance

of the Consolidation Bank. The new management has started tackling the complicated organisational structure, cutting costs and improving productivity.

Aerospace engineering is an important subsector, where large foreign investors, such as Boeing (US), and Triplex Lloyd (UK), are present. In 1997, a consortium led by Boeing E and including McDonnell Douglas Aerospace and Czech Airlines, bought 35 per cent of Aero Vodochody, the country's sole producer of military aircraft. Aero Vodochody is a successful company: in 2000, it signed a contract worth USD 230 million to produce components for the S-76C civilian helicopter, produced by the U.S. company Sikorsky Aircraft. It also won an order for 72 L-159 planes from the Czech Army worth CZK 30 billion. Another important player in the sector is Let a.s., the largest Czech civilian aircraft manufacturer, which was acquired by Ayres Corp in 1998. However, the company has run into difficulties and was declared bankrupt in October 2000. LET's bankruptcy administration is now looking for another strategic investor for the company.

Metallurgy

Restructuring of the steel industry took on pace in 2000, following a crisis in the sector due partly to the failure of previous restructuring efforts and also to the negative effect of low world steel prices and rising imports in 1999. Around 90 per cent of steel production is concentrated in three steelworks – Nová Hut', Třinecké železářny and Železářny Vitkovice – all located in the north-eastern part of the country, which is part of black coal mining region close to the borders with Poland and Slovakia. The government has approved a detailed restructuring plan for the sector.

In parallel with the restructuring the government is also trying to privatise two of the troubled steel factories. Pressure for privatisation is strongest in the case of Nová Hut', where the International Finance Corporation (IFC) – a key creditor – has exerted pressure to complete the company's sale to a strategic investor. Plans for the Vitkovice plant include erasing some CZK 11 billion (US\$ 314 million) of its debt and then splitting it into four main units to be sold off to investors. Třinecké železářny, which is 70 per cent owned by Moravia Steel, has been the most successful of the steelworks. In March 2000, 11 per cent of the company was sold to the Swiss unit of Commercial Metals Company (US). Moravia Steel's stake dropped to 63 per cent after the deal. Commercial Metals and Moravia Steel have also signed an agreement on marketing and trade activities.

Environment

Waste management

Waste and waste-water management is an area that offers investment opportunities for investors. Environmental spending has been steeply increasing in view of EU accession. The environment is one of the most demanding in terms of the process of preparation for accession to the EU. The Czech government estimates the total figure for harmonisation with EU environmental standards at about US\$ 6.8 billion. Of this 60-70 per cent applies to the private sector. US\$ 3.5 billion is needed to be invested into water management, US\$ 700 million into waste-water management, US\$ 700 million into industrial pollution control and risk management and US\$ 300 million into clean air.

The country currently spends 2.5-3 per cent of GDP on environmental protection. The government can expect about 8 per cent of the total costs of harmonisation to come from the EU through pre-entry programs such as ISPA (Instrument for Structural Policies for Pre-accession). The EU Phare programme has already spent more than US\$ 80 million on the environment, of which US\$ 45 million has gone to preventing cross boundary pollution.

Foreign firms active in the Czech market include Cottrell, BHA International, REO-RWE Entsorgung, Rumpold, and Rethmann (all Germany), Lennox Industries and Ecofluid (USA), Marius Pedersen (Denmark), Hoval and ASA (Austria), Nijhuis Water Technology (Holland), Kemira Group (Finland), and ATE (France).

Water management

As a result of privatisation, a number of foreign, mainly English and French, companies already possess stakes in the water sector. Anglian Water (UK) controls Severomoravské vodovody a kanalizace (SMVAK, or North Moravian water and sewerage), and Vodovody a kanalizace Jižní Čechy (VAKJC, South Bohemia). Vivendi Water (France) owns Severočeské vodovody a kanalizace (SVAK, North Bohemia), Jihočeské vodovody a kanalizace České Budějovice and the water and sewerage

companies in the cities of Plzeň and Olomouc. The biggest investments of Suez Lyonnaise des Eaux (France) are its controlling stakes in the Ostrava, Brno and Karlovy Vary city water companies. German investors hold less important stakes in other water firms, mainly in Western Bohemia.

In February 2001, the National Property Fund signed a contract on the purchase of Pražské vodovody a kanalizace (PVK), the Prague water and sewage company, with Vivendi/Anglian Water consortium, Prague Water CGE-AW. The French-British team beat two other bidders, Suez Lyonnaise des Eaux (France), and the International Water/United Utilities consortium, in a tender for the state's 66 per cent stake in PVK. The winning consortium offered CZK 6.1 billion (€ 174 million). The facility is the largest Czech water company and is also regarded as the most profitable.

Western investors see the Czech water sector as very attractive for investment. Already privatised facilities are reported to be highly profitable. A further increase in profitability is expected as accession to the EU is almost certain to bring price increases as companies are forced to fulfil EU environmental regulations, and as standards of living rise.

The Czech government will nevertheless need to invest large resources in the coming years to meet EU standards. The major issues to tackle are sewage and waste-water management, the reduction of pipeline leakage and the extension of the drinking water network.

International institutions are providing support for projects to modernise the water network. The Brno water company, Brněnské vodárny a kanalizace used a loan from the EBRD and a grant from the European Commission to update water and waste-water facilities. The European Investment Bank has also promised to lend CZK 1.9 billion for the repairs of Prague's ageing water network.



Financial sector

The year 2000 was rich in events for the Czech banking sector. The government continued the difficult task of bank consolidation: the privatisation of Česká spořitelna (ČS) was completed and Investiční a Poštovní banka (IPB) was taken over by ČSOB. Foreign involvement has been steadily increasing both in the banking and non-banking segments of the market, and the adjustment of the regulatory environment to EU standards speeded up significantly. Recent improvements in legislation and the general recovery of the Czech economy resulted in better capital market performance in 2000.

Banking sector

The institutional framework of the Czech banking sector improved during 2000 and Czech banking regulations have reached a high level of harmonisation with EU directives and other international standards. Efforts to overcome the remaining differences, mainly in the area of banking supervision on a consolidated basis, are at an advanced stage. Full harmonisation of the banking legislation with the *acquis communautaire* is expected within one year.

The national accounting standards for banks are almost fully in line with IAS, although some shortcomings remain in the area of consolidation and with regard to some financial instruments. The legal framework for external auditors' activities, including their obligations with respect to the supervisory authorities, is now compliant with EU requirements. The Act on Banks also regulates this area sufficiently. Auditing methods are in line with international practices.

In order to improve creditors' rights, several important amendments to the Civil Code, the Code of Civil Procedure and the Act on Bankruptcy and Settlement have been adopted, and a new Act on Public Auctions has entered into force.

The Chamber of Deputies passed a new law governing the Czech National Bank (CNB), the central bank, in December 2000. The main aim of the new Act is to align the status and functioning of the central bank with the EU's *acquis communautaire*. The latest EU Progress Report on the Czech Republic praised the administrative capacity of the CNB and also noted that its set of monetary instruments is largely adjusted to the ECB framework, with the exception of the minimum reserve requirements. On the other hand, the document criticised elements of the new Act that would limit the independence of the CNB.

The total assets of the Czech banking sector amount to 144 per cent of GDP. As at 31 December 2000, there were 40 banks and foreign bank branches. The share of the foreign banks and the banks controlled by foreign strategic investors in the Czech banking sector had reached 70 per

cent and will grow further once the privatisation of Komerční banka is completed.

At the end of 2000 the Czech banking sector consisted of three large banks (ČSOB, Česká spořitelna and Komerční banka), Konsolidační banka, a state-owned bank, 12 medium sized banks, eight small banks, 10 foreign bank branches, and six building societies.

During the last two years, the Czech government has restructured the banking sector and successfully completed the privatisation of **Československá obchodní banka** (ČSOB) in 1999 and of Česká spořitelna in 2000. ČSOB was sold to Belgium's KBC Bank for over € 1 billion. As a second step, in December 1999 KBC Bank and the EBRD jointly purchased the 24.13 per cent stake in ČSOB still held by the Slovak government following the split of the Czech and Slovak Republic in 1993. Following the conclusion of these two deals, KBC has an 82.35 per cent stake in ČSOB, the EBRD holds 7.47 per cent and the IFC 4.39 per cent.

Another important privatisation deal was the sale of **Česká spořitelna** (ČS, the Czech savings bank), completed in February 2000. A 52 per cent stake held by the state was sold to Austria's Erste Bank AG. Under the main terms of the deal, Erste Bank paid € 529 million and pledged to increase ČS's share capital by CZK 4 billion within the next two years, while the government agreed to guarantee the remaining bad loan portfolio and any off-balance sheet risks. Following its take-over of ČS, Erste Bank launched a two-year restructuring programme aimed at boosting consolidated return on equity from the current 3 per cent to 18 per cent by the end of 2002, while the cost-to-income ratio should drop from around 90 to below 70 per cent. To achieve these targets the bank plans to reduce the workforce and invest US\$ 121.5 million, much of which will be used for information technology upgrades.

The EBRD made an active contribution to the restructuring of ČS and its preparation for sale. Firstly, it purchased 9 million shares in ČS, equivalent to 11.8 per cent of the bank's registered share capital for an aggregate purchase price of ECU 66.2 million. In addition, the EBRD has played a very active advisory role.

The last large state-owned Czech bank **Komerční banka** (KB) is now undergoing privatisation and the first bids from potential strategic investors are expected at the end of April 2001. The bank was consolidated through a huge bailout and the transfer of bad assets arranged by the Czech government last year. In addition, the management of KB has been replaced in order to strengthen the bank before sale.

In June 2000 conservatorship was imposed on **Investiční a poštovní banka** (IPB), at that time the third largest commercial bank. The bank was illiquid and had lost the confidence of the interbank market. The imposition of conservatorship was an inevitable and necessary preventive measure to avoid a systemic crisis in the Czech banking sector. IPB's assets, liabilities and branch network were taken over by ČSOB. The Czech government issued a guarantee for losses from IPB's bad assets and the CNB issued a guarantee for IPB's deposits and to the bank's clients.

Non-bank financial institutions

Stock exchange

The Czech Republic has an advanced equity market. The Prague Stock Exchange was founded in 1993. Its main exchange index, the PX50, comprises 50 stocks selected according to their market capitalisation and turnover volume.

Following years of difficulties, the PSE is now in the process of a successful consolidation brought about by legislative reforms and the improving performance of the Czech economy. These changes have been helping to increase liquidity, although the number of actively traded stocks is still low, with telecommunications company stocks and the large banks accounting for almost two-thirds of equity turnover. Analysts expect a change in the attitude of Czech companies towards the stock exchange as a source of financing in the years ahead, and that it will come to replace venture capital or strategic investment.

In the last few years, the PSE has taken a number of steps to improve its regulatory framework and structures. The establishment of a semi-independent securities commission (SEC) in 1998 was one of the most important. This body is responsible for the supervision of the capital markets and has the power to impose fines, prevent the trading and movement of securities and freeze financial assets. The SEC's operations have greatly improved investor confidence in the capital markets. New legislation on securities aligning the regulations with EU standards was enacted in January 2001.

An outstanding task is to reduce the fragmentation of the local stock market, a move that would eliminate the practice of divergent prices for the same stock at different exchanges.

In 2000, the main market indicators rose as the combined result of the recovery of the Czech economy, higher foreign investment, and acceleration in the pace of bank privatisation. Trading volumes rose 68 per cent year on year in the first nine months of 2000. Further progress is expected to result from regulatory improvements in the insurance sector and deeper structural reform of the pension system.

Insurance

The insurance sector is relatively well developed, with around 40 insurance companies operating in the market. In 2000, the legislation progressed further towards EU requirements: a new Insurance Act in line with the *acquis* entered into force in April, setting the framework for an overall restructuring of the sector and improvement of supervision.

The sector is highly concentrated, with one company, Česká pojišťovna (CP), accounting for around 40 per cent of the market. The controlling shareholder of CP is the První Privatizační Fund (PPF), a Czech investment group. The dominance of CP has been progressively eroded over the last few years. Its share in the domestic market dropped by 10 per cent alone in the first half of 2000, largely due to the abolition of its monopoly on third-party car insurance. The market is also being reorganised by other regulatory changes heralded by the new Insurance Act approved in late 1999. The Act requires insurers to split life and non-life insurance activities into different companies. In addition, the Ministry of Finance no longer approves in detail business plans and insurance products offered by insurance providers, but concentrates on supervision instead.

Alongside regulatory change the number of competitors has also been increasing. Several of the largest Czech banks have set up their own insurance subsidiaries (such as ČSOB Pojišťovna, Komerční Pojišťovna, etc.) and are utilising their branch networks to distribute insurance products. Foreign insurers are also increasing their market position. The largest foreign insurers present in the market are: Nationale Nederlanden (Netherlands), Generali (Italy), Allianz (Germany), Winterthur and Zurich (both Switzerland).

The EBRD has made two investments in the insurance sector. In 1995, the Swiss insurance company Winterthur received a CHF 100 million worth multi-project facility to support its

investment programme in central and eastern Europe, including the Czech Republic. Secondly, the EBRD invested € 2.7 million in the share capital of Česko Rakouska Pojišť'ovna (CRP), the tenth largest Czech insurance company, owned by BARC of Austria. CRP is a composite insurer predominantly operating in the non-life market and offers over 30 lines of business.

Pension funds

The Czech Republic relies on a pay-as-you-go system (Pillar I) and also has a small but growing voluntary pension fund system (Pillar III). (Pillar II, a fully funded mandatory defined contribution scheme that was recently established in Poland and Hungary, has not been introduced.) Contributions to voluntary pension funds increased rapidly in 2000, largely as a result of tax breaks introduced for contributions in 1999. In anticipation of continued growth and further positive legislative change, pension funds and insurers have been actively manoeuvring for a market share in 2000. Several of the country's independent funds joined international finance and insurance groups last year. In the largest deal, Winterthur (Switzerland) is taking over Union Group and its Vojensky Otevřeny Penzijní Fond, the largest domestic pension fund. The Swiss company already operates two Czech pension funds, Penzijní Fond and Banský a Hutní. Dutch bank ABN-Amro took a majority stake in the Jistota a Koruna fund in September 2000. Finally, British insurer CGNU bought a majority stake in the Všeobecný Vzájemný Pensijní Fond in November 2000.

EBRD activities in the Czech Republic



As at 31 December 2000, the European Bank for Reconstruction and Development (EBRD) had signed 36 projects in the Czech Republic with a total Bank investment of € 695.0 million. Nineteen equity investments (€ 272.5 million) and 19 loans (€ 451.7 million) have been signed in support of enterprises involved in food processing, agriculture, telecommunications, the financial sector, the automotive industry, energy efficiency, infrastructure, textiles, pulp and paper, weaving, casting and heavy machinery.

With only two signed public sector projects (Czech Telecommunications (€ 45.1 million) and Czech Railways (€ 20.0 million) – the EBRD portfolio enjoys one of the highest private sector ratios (90.6 per cent). The country is also benefiting from a number of regional projects. In the private sector, the EBRD signed new projects in 2000 focusing on SME banking, energy efficiency

The EBRD has a number of projects in the pipeline, covering a variety of sectors, such as manufacturing, transport, telecommunications, finance municipal services and energy efficiency.

Overview of EBRD activities and main objectives

The EBRD's strategy for the Czech Republic focuses on the areas outlined below.

Infrastructure and environmental sectors

Municipal and environmental infrastructure requires an increased level of investment if the Czech Republic is to follow a fast track to accession to the European Union. The EBRD will seek to raise the level of its activities, in close co-operation with the European Commission's programmes like ISPA.

Priority areas will include water supply and urban transport services, environmental activities and energy and energy efficiency operations. In particular, the EBRD will seek to invest in projects intended to reduce emissions of greenhouse gases and in those that can benefit from joint implementation. The Bank will also work in other infrastructure sectors, such as telecommunications, energy, transport, agriculture and property/tourism.

Financial sector

The EBRD will support the completion of the privatisation of the banking sector and enhance the emergence of viable non-bank financial institutions (such as insurance and pension funds). The Bank's involvement attracts strategic investors and improves credit and risk management standards, thereby contributing to better management of the corporate loan market. This will help to improve the financial viability of the corporate sector.

Corporate sector

The EBRD will promote financial and operational restructuring and improvement in corporate governance for private enterprises. To achieve this, the Bank will look for opportunities to enter into viable corporate restructuring operations and will work with the local corporate sector.

The EBRD aims to reduce the enterprise sector's dependence on short-term loans, to simplify and strengthen shareholding structures, to promote equity investments, and to provide a basis for long-term borrowing, thereby also contributing to restructuring and modernisation.

To achieve this objective, the EBRD will work more closely with local investment funds and financial institutions, and could participate in co-underwriting initial public offerings on the Prague Stock Exchange. This is to be complemented by further support for small and medium-sized enterprises (SMEs) to enhance economic and employment opportunities in new growth sectors and to promote competition in traditional sectors. In particular, support will be provided through the SME Facility that has been developed jointly with the European Commission. The Bank's Trade Facilitation Programme will support the export function of Czech industry to the EBRD's countries of operations. These markets are opening new opportunities for Czech capital goods and services.

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Signed projects as at 31 December 2000 (in € million), exchange rates as at 31 December 2000

Operation name	Sector	Total cost	EBRD debt	EBRD equity	EBRD total
Private					
CZ-Cagiva	Automotive	36.9	5.9	0	5.9
Karosa	Automotive	37.2	0	6.5	6.5
Barum/Continental	Automotive	155.7	29.6	17.4	29.6
L&G ESCO Czech Republic	Energy efficiency	1.8	0.4	0.2	0.6
Harpen ČR	Energy efficiency	37.6	17.1	0	17.1
Komerční banka - Trade Facility	Finance	16.1	16.1	0	16.1
Investicní a Poštovní banka	Finance	53.7	8.4	0	8.4
Česká spořitelna Pre-Privatisation Equity	Finance	69.8	0	67.0	67.0
Česká spořitelna SME Facility	Finance	20.0	20.0	0	20.0
ČSOB Privatisation Equity	Finance	125.0	132.2	0	132.2
GIMV Czech & Slovak SME Fund	Finance	12.0	0	1.5	1.5
MBA Loan project	Finance	6.5	0	0.3	0.3
Advent International	Equity funds	10.7	0	10.7	10.7
Czech Private Equity Fund	Equity funds	46.3	0	2.3	2.3
Czech Direct Equity Fund	Equity funds	63.6	0	25.4	25.4
Winterthur MPF- Pojišť'ovna	Insurance	22.5	0	7.8	7.8
Česko Rakouska Pojišť'ovna capital increase	Insurance	2.9	0	2.8	2.8
SIS Funds	Mutual funds	32.8	0	9.7	9.7
Winterthur MPF-Penzijní Fond	Pension funds	2.6	0	0.9	0.9
Čokoladovny	Food processing	156.7	0	23.3	23.3
TTD/Dobrovice	Food processing	23.5	0	4.2	4.2
Škoda Kovarný	Metal products	24.7	16.8	0	16.8
Tatrarex	Metal products	2.0	0.8	0	0.8
Korado	Metal products	122.5	0	29.9	29.9
Tesla-Y.S.	Mineral products	18.8	8.0	0	8.0
Sepap Steti	Paper manufacturing	153.4	56.8	0	56.8
European Property Group	Real estate	152.3	0	36.1	36.1
Heitman Central Europe Property Partners Fund	Real estate	142.3	10.0	0	10.0
Eurotel Praha	Telecommunications	66.6	11.8	0	11.8
Kabel Net	Telecommunications	14.1	0	2.5	2.5
Technolen WF	Textiles	14.8	8.6	0	8.6
CES Uniweb	Textiles	6.3	1.6	0	1.6
ČSA	Air transportation	32.7	0	24.0	24.0
Brněnské vodárny a kanalizace	Water and sewage	74.7	42.5	0	42.5
Sub-total		1,759.1	386.6	272.5	641.7
Public:					
Czech telecommunications project	Telecommunications	268.2	45.1	0	45.1
České dráhy - Czech railway corridor	Rail transportation	1,005.0	20.0	0	20.0
Sub-total		1,273.2	65.1	0	65.1
Total		3,032.3	451.7	272.5	706.8
of which private					90.8%
of which public					9.2%